Surviving Once a Decade Disasters: The Cost of Companies Not Keeping Enough Cash on Hand

By Geoff Gannon

A couple days back, I read Tilman Fertitta's book "Shut Up and Listen". The book is short. And it's full of a lot of basic, good advice especially for someone looking to build a big hospitality business (which is what Fertitta did). What stood out to me is how practical the book is about stuff I see all the time in investing, but rarely gets covered in business books. The best example of this is a chapter on "working capital". Value investors know the concept of working capital well, because Ben Graham's net-net strategy is built on it. But, working capital is also important as a measure of liquidity.

A lot of value investors focus on the amount of leverage a company is using. The most common metric used is Debt/EBITDA. Certain Debt/EBITDA ratios are considered safe for certain industries. It might be considered fine to leverage a diversified group of apartment buildings at Debt/EBITDA of 6 to 1 but risky to leverage a single cement plant at Debt/EBITDA of 3 to 1. There is a logic to this. And some companies do simply take on too much debt relative to EBITDA. But, that's not usually the problem that is going to risk massive dilution of your shares, sales of assets at bad prices, bankruptcy etc. in some investment. The usual issue is liquidity. If you borrow 3 times Debt/EBITDA and keep zero cash on hand and all your debt can be called at any time within 1-2 years from now – that's potentially a lot riskier than if you have borrowed 4 times Debt/EBITDA and are keeping a year of EBITDA on hand in cash at all times and your debt is due in 3 equal amounts 3, 6, and 9 years from today. The difference between these two set-ups is meaningless in good times. As long as credit is available, investors who focus only on Debt/EBITDA will never have to worry about when that debt is due and how much cash is on hand now. However, at a time like COVID – they will. Times like COVID happen more often than you'd think. Fertitta is in the restaurant business. He's seen 3 liquidity crunches for restaurants in the last 20 years. There was September 11th, the collapse of Lehman Brothers, and now COVID. He got his start in the Houston area. Not much more than a decade before the first 3 of those events I listed above – there was a collapse of the Texas banking system that resulted in a lot of Texas banks (and all but one of the big ones) closing down. That was also a possible extinction level event for restaurants in the state. So, using Fertitta's 30-40 years in the restaurant business as an example, extinction level risks that depend on a restaurant company maintaining some liquidity to survive seem to happen as frequently as once every 10 years. When looking at a stock's record over 30 years – the difference between a stock with a 10% chance of going to zero happening once every 10 years versus a stock with a 0% chance of going to zero for the full 30 years is pretty meaningful. In fact, if you find a stock you expect to compound at like 12% a year while the market compounds at 8% a year – but, you neglect to notice it has a 10% chance of complete failure once every 10 years, your above average investment will be reduced to basically an average investment. A 70-75% chance of compounding at 12% a year combined with a 25-30% chance of losing everything in a stock is not very different from a 100% chance of getting an 8% annual return. We can see this in the restaurant business. Over a sufficiently long investment timeline, a surprising number of restaurant companies – I mean here full-service restaurant concepts, not fast food – would have stocks that ended up going to zero. Loss of popularity of the concept in the face of changing customer tastes and especially competition that is better suited to those tastes is one explanation. But, liquidity problems are often a big factor too. If a restaurant business has borrowed 3 times Debt/EBITDA (or is renting space to create much the same fixed charges in cash as they'd have if borrowing that much), then it doesn't take a very large decline in sales to create a very big problem in terms of cash generation beyond meeting debt payments and refunding that debt. A restaurant can have a 50% decline in EBITDA on a much lower than 50% decline in sales. It is not hard to imagine just a 20-30% decline in sales causing your Debt/EBITDA to jump from less than 3 times to more than 6 times. This becomes a problem, because access to funding will become worse for the company if sales are headed in the wrong direction. You can't issue a lot of stock, borrow a lot more from banks, etc. when your sales are 20-30% off their all-time peak. You can when you are setting new revenue records every year. But, of course, if your sales are growing every year, so is your EBITDA – and so, you probably don't need to increase your Debt/EBITDA ratio anyway.

That's why Fertitta gives the same advice as Buffett – borrow when money is available, not when you need it. A big reason why a lot of stocks in industries very badly hit by COVID dropped to such lows in late March and have risen to such highs now is because of the availability of funding. If you were a cruise line, a restaurant, a theme park, etc. – you couldn't access more credit in March. Once your cash ran out, you were going to be in a very bad position that was definitely going to destroy a lot of shareholder value. A few months later – in fact, in some cases it was just a few weeks later – these companies were able to access a lot of capital. That, more than anything else, changed the likely value of their stocks as long-term investment. So, if there was a real chance the lack of access to capital was going to stay permanent back in March and there's a real chance the access to capital is going to stay permanent now – those crazy swings in some of those stock prices could actually have been fully justified. Without access to capital, some of these companies would've run out of cash pretty quickly. If you have no cash and do have debt – that is usually a very bad position for protecting the value of your business for shareholders. The assets of the business – the actual parks and cruise ships and so on – will recover operationally at some point. But, your shareholders are unlikely to own the same proportion of them when earnings do rebound.

But, what if access to capital for COVID hit industries hadn't loosened up? What if it stayed like it was in March? Or what if it happens again? Then, it would've made a very big difference if a company was sitting on cash and had its debts spread out over many years versus a company with little cash and a lot of debt due soon. None of this is captured by the Debt/EBITDA ratio. It's not just measures of leverage that matter. It's also measures of liquidity.

How much do they matter?

Well, if you assume that – because of likely government policy you could've guessed about in advance – the chance of COVID hit industries being completely starved of capital for months or years was very unlikely (say a 20% chance of no access and 80% chance of access returning to where it was before COVID), each company's liquidity position would've mattered a lot. A 20% chance of a 50% destruction of shareholder value – since the equity is the most junior position in the capital structure and these companies use leverage, a 50% decline in a stock's intrinsic value could happen even when the intrinsic value of the entire enterprise contracts much less – would be a 10% difference in the value of the business. A one-time 10% difference may not sound very big – stocks moved by more than that on a daily basis during the worst part of the market's COVID related drop. But, consider that if it's pretty realistic that there could be at least a 20% chance of a 50% destruction of shareholder value due to these "once a decade" events, this is a 1% annual performance difference between a stock that runs this risk and a stock that doesn't. This is true for long-term holdings that are not entered into at periods where risks are especially elevated. Obviously, right now, the risk of more immediate adverse consequences to holding too little cash and having too much debt due too soon presents an even bigger risk. Your expected return in a stock with a strong liquidity position versus a weak liquidity position may only be 1%

different over 30 years or something. But, it's obviously a lot more than a 1% annual difference in expected return when you are in or near an actual or potential liquidity crisis. If there is the same risk of damage as in other periods, but the possible occurrence of the damage is a lot sooner – the odds of liquidity problems in the next year or so after you buy the stock today are higher than usual – then the difference in expected return for you is going to be a lot worse in the stock with less liquidity.

For investors, the important thing is to try to worry most about liquidity when the market is not. This allows you to get out of stocks with bad liquidity positions while their prices are still good. If you wait till times like this March to get out of stocks with poor liquidity positions – you'll pay an absurd premium for insurance against insolvency. If a stock is down 50-90% due to concerns about insolvency, selling that stock because you share those concerns is not likely to make a lot of sense. It would only make sense if you felt pretty confident you were buying insurance – limiting your loss by selling now – on an event (like actual bankruptcy) that was probably going to occur. That's not a good bet to take. The best bet to take is to find two similarly situated companies during good times, normal times, etc. where there is not much of a difference in price between the two stocks despite one stock having plenty of cash and debt that isn't due for a while and the other having very little cash and debt due much sooner. That's the time to avoid the company that is worse positioned for that one every decade extinction level liquidity event.

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